

STATE BOARD OF ACCOUNTS
302 West Washington Street
Room E418
INDIANAPOLIS, INDIANA 46204-2765

AUDIT REPORT
OF
COMPREHENSIVE ANNUAL FINANCIAL REPORT
STATE OF INDIANA
July 1, 2003 to June 30, 2004



TABLE OF CONTENTS

<u>Description</u>	<u>Page</u>
Schedule of Officials.....	2
Transmittal Letter	3
Audit Results and Comments:	
Local Option Income Taxes	4-5
Infrastructure.....	5
Capital Leases	5
Exit Conference.....	6
Official Response	7-11

SCHEDULE OF OFFICIALS

<u>Office</u>	<u>Official</u>	<u>Term</u>
Governor	Hon. Frank O'Bannon (Deceased)	01-08-01 to 09-13-03
	Hon. Joseph E. Kernan (Interim)	09-09-03 to 09-12-03
	Hon. Joseph E. Kernan	09-13-03 to 01-09-05
	Hon. Mitchell E. Daniels, Jr.	01-10-05 to 01-11-09
Auditor of State	Hon. Connie K. Nass	01-01-03 to 12-31-06
State Budget Agency	Marilyn F. Schultz	01-08-01 to 01-09-05
	Charles E. Schalliol	01-10-05 to 01-11-09



STATE OF INDIANA

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TO: THE OFFICIALS OF STATE OF INDIANA

We have audited the financial statements of the State of Indiana as of and for the year ended June 30, 2004, and have issued our opinion thereon dated December 28, 2004. The financial transactions of the State of Indiana are reflected in the State of Indiana's Comprehensive Annual Financial Report (CAFR).

In planning and performing our audit, we considered the internal controls over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted certain conditions in the design or operation of one or more of the internal control components that, in our judgment, need to be addressed by management to strengthen their internal controls.

The internal control conditions are disclosed in the following audit results and comments.

STATE BOARD OF ACCOUNTS

December 28, 2004

STATE OF INDIANA
AUDIT RESULTS AND COMMENTS
June 30, 2004

LOCAL OPTION INCOME TAXES

A material portion of the local option income tax (LOIT) revenues collected by the Department of Revenue (DOR) on behalf of counties is withheld from employee paychecks by employers and remitted to DOR throughout the year. Employers do not provide county breakouts for these payments. The DOR is unable to determine the specific county breakouts until amounts withheld and remitted in the current year are processed on individual tax returns filed in the following year. Therefore, real-time information is not available for LOIT revenues.

The State Budget Agency (SBA) records monthly LOIT revenues, distributions, and compounded interest by county on its system. In the absence of real-time information, SBA records an estimate of current period revenue until the processed amount is confirmed in the subsequent year. Prior to July 1, 2002, this estimate was based on revenue forecasts also used by SBA to recommend the certified distribution for the subsequent year. Under existing law, certified distributions are based on processed amounts, not forecasts. Therefore, the most recently available information regarding processed amounts is now used to estimate current period revenue until updated amounts become available in the subsequent period.

In the absence of real-time information, deposits recorded on the Auditor of State (AOS) system for LOIT fund/centers represent transfers from the General Fund to cover certified distributions, not actual revenues. Revenues, and the corresponding interest imputed to counties, are recorded on SBA's system using estimates for the current period.

LOIT recording procedures depend on timely communication between DOR, SBA and AOS. We identified the following control weaknesses in these procedures:

1. No single agency or department maintained a master schedule of county taxes, rate changes and effective dates, and special taxing districts.
2. An adequate audit trail did not exist for CAGIT and CEDIT transactions because county-specific fund/centers were not utilized.
3. Inconsistent procedures were employed to record distributions to special taxing districts.
4. Special taxing district distributions were not clearly identified on SBA's Trust Balance History Reports. Instead, they were listed in the same column as special distributions made to counties.
5. Reconciliations were not performed between DOR, SBA and AOS records. If distributions and transfers are correctly recorded and reconciliations are correctly performed, all county and special taxing district fund/centers should be zero-balancing.

IC 6-3.5-1.1-8 states: "A special account within the state general fund shall be established for each county adopting the county adjusted gross income tax. Any revenue derived from the imposition of the county adjusted gross income tax by a county shall be deposited in that county's account in the state general fund." IC 6-3.5-7-10 states: "A special account within the state general fund shall be established for each county adopting the county economic development income tax. Any revenue derived from the imposition of the county economic development income tax by a county shall be deposited in that county's account in the state general fund."

STATE OF INDIANA
AUDIT RESULTS AND COMMENTS
June 30, 2004
(Continued)

The proper utilization of the state system includes the objectives of: timely submission of documents; proper classification of the transaction; recording of accurate amounts; and verification of correct posting to reports. It should be noted that the Auditor of State system and related reports constitute the official record of the budget, cash receipts and disbursements. As such, the individual agency's accounting system should operate congruently with the state system with reconciliations of as much information as is practicable. (Accounting and Uniform Guidelines Manual for State Agencies, Chapter 1)

INFRASTRUCTURE

As stated in the prior Audit Report B22341, the Indiana Department of Transportation (INDOT) does not have complete written internal procedures to ensure that all applicable infrastructure assets are capitalized on the Auditor of State's capital asset system. INDOT has not documented procedures that would enable employees to determine which costs and at what point in the process these costs should be capitalized. This results in an understatement of the State's capital assets.

The Governmental Accounting Standards Board requires the capitalization of additions and improvements of a government's infrastructure assets.

Each agency, department, institution or office is responsible for compliance with applicable statutes, regulations, contract provisions, state policies, and federal requirements. Compliance is required, as applicable, with generally accepted accounting principles, and standards issued by the Governmental Accounting Standards Board, Financial Accounting Standards Board, and other standard setting bodies. (Accounting and Uniform Compliance Guidelines Manual for State Agencies, Chapter 1)

CAPITAL LEASES

As stated in the prior Audit Report B22341, the Procurement Division of the Indiana Department of Administration maintains a database of lease activity. Procedures in place to update the lease database do not ensure that all qualifying leases are entered into the database, resulting in the database not being complete.

Adequate lease records should be maintained by the Department of Administration to ensure that lease obligations are properly presented in the State's financial statements in accordance with standards issued by the Financial Accounting Standards Board.

Each agency, department, institution or office is responsible for compliance with applicable statutes, regulations, contract provisions, state policies, and federal requirements. Compliance is required, as applicable, with generally accepted accounting principles, and standards issued by the Governmental Accounting Standards Board, Financial Accounting Standards Board, and other standard setting bodies. (Accounting and Uniform Compliance Guidelines Manual for State Agencies, Chapter 1)

STATE OF INDIANA
EXIT CONFERENCE

The contents of this report were discussed on May 12, 2005, with Connie Nass, Auditor of State; and Anthony Armstrong, Deputy Director, State Budget Agency. Their official responses to the audit findings have been made a part of this report and may be found pages 7 through 10.

The finding relating to infrastructure was discussed on March 11, 2005, with Tony Hedge, Controller, Indiana Department of Transportation. The official response to the audit finding has been made a part of this report and may be found on page 11.



STATE OF INDIANA

Mitchell E. Daniels
Governor

OFFICE OF MANAGEMENT & BUDGET

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Charles E. Schalliol
Director

June 3, 2005

Ms. Marilyn Rudolph
Interim State Examiner
State Board of Accounts
Indiana Government Center South
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Indianapolis, IN 46204

Dear Ms. Rudolph:

We have reviewed the State Board of Accounts' comments received on May 19, 2005 regarding the administration of local income taxes. In accordance with IC 5-11-5-1, this letter is our response to the State Board of Accounts' comments regarding the presence of certain control weaknesses.

1. No single agency or department maintained a master schedule of county taxes, rate changes and effective dates, and special taxing districts.

By law, counties are required to send ordinances imposing, increasing, decreasing, or rescinding a local income tax (LOIT) to the Department of Revenue. In addition, county auditors are required to annually certify the tax rates for their county to the Department prior to July 1. These documents are used to construct a table containing tax rate information for the current state fiscal year and the coming state fiscal year. After internal review for accuracy, the table is forwarded to the State Budget Agency for entry into its LOIT accounting system. The State Budget Agency assigns one person to enter the rate information and one person to review the entries for accuracy. The LOIT accounting system can be used to produce a historical report of the tax rates in effect since the date of adoption for any county and tax type.

2. An adequate audit trail did not exist for CAGIT and CEDIT transactions because county-specific fund/centers were not utilized.

As the State Board of Accounts has correctly recognized, making local income tax distributions from one fund/center for CAGIT and one fund/center for CEDIT makes reconciling distributions actually made by the Auditor of State and

June 6, 2005

distributions recorded in the State Budget Agency's LOIT accounting system extremely difficult using the Auditor of State's object trial balance reports or Alchemy system.

However, the State Budget Agency has access to the individual transactions underlying the Auditor of State's object trial balance reports. Using the data at this level of detail, the Budget Agency is able to identify individual distributions of local income taxes by tax type. This data can be used to audit CAGIT and CEDIT transactions without necessitating the use of individual fund/centers.

3. Inconsistent procedures were employed to record distributions to special taxing districts.

The statute for the professional sports development area caps the amount of money that is distributed from sales and the adjusted gross income tax. When the cap is reached, no additional funds are distributed from those two sources. The problem that arises is that withholding amounts that are paid by the employers include both state and local income taxes. The local breakdown is not available until several months after the end of the calendar year. The cap limit is set on a fiscal year basis. The amount that is reallocated from the local option income tax for a calendar year reflects the distributions made over two fiscal years. In the initial years for Marion County's distribution, the Department failed to report the local option income tax amounts to the Budget Agency. This failure was corrected and is now annually reported to the Budget Agency.

Community revitalization enhancement districts and certified technology parks income tax incremental amounts are also based on a fiscal year basis. The reporting requirement of the district is to provide a listing to the Department of all employers in the district before July 1 of each year. The Department is then required to determine the incremental amount within sixty days. The problem in many cases is that the local unit only provides the name of a business, which can be a DBA and not the formal name. Also, the taxpayer identification number is not supplied in many instances, so the Department is required to either contact the taxpayer directly, or try to determine the entity through an alpha search of the Department's computer system. Legislative changes have been proposed to require more detailed reporting from the districts concerning the businesses in the district.

4. Special taxing district distributions were not clearly identified on SBA's Trust Balance History Reports (TBHRs). Instead, they were listed in the same column as special distributions made to counties.

There are currently four types of special taxing districts as the State Board of Accounts uses the term. To separately state distributions to each type of district would require the addition of four columns to the TBHR. For the majority of

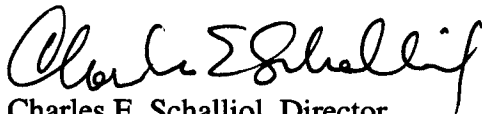
counties the additional columns would not be relevant at the present time and may well be irrelevant in the future.

The State Budget Agency's LOIT accounting system currently accommodates footnotes to the TBHRs. The Budget Agency will begin documenting the nature and amounts of special distributions using the footnote capability.

5. Reconciliations were not performed between DOR, SBA and AOS records. If distributions and transfers are correctly recorded and reconciliations are correctly performed, all county and special taxing district fund/centers should be zero-balancing.

Using the transactions-level data described in item (2), the State Budget Agency will begin reconciling between DoR, SBA, and AoS on a monthly basis.

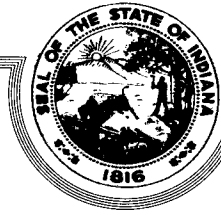
Sincerely,



Charles E. Schalliol, Director
Office of Management and Budget

Auditor of State

CONNIE K. NASS



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To: Marilyn Rudolph, CPA, Interim State Examiner
From: Connie K. Nass *CKN*
Date: June 2, 2005
Re: Audit Report of the State of Indiana Comprehensive Annual Financial Report for the period July 1, 2003 to June 30, 2004.

This memo constitutes the Auditor of State's official response to the audit finding concerning local option income taxes.

The Auditor's office acknowledges that the current method of accounting for local option income taxes is problematic and has been since its inception. We agree with the suggestion that the statewide balance of local option income taxes should be posted to control accounts in the general ledger for each type of tax and that county-specific fund/centers, which are currently available, should be used as zero-balancing cash clearing accounts for the distributions of the LOIT. We also agree that fund/centers should also be set up for special taxing districts. The Auditor's office will work with the Department of Revenue, Office of Management and Budget, and the State Budget Agency to develop a method of accounting for local option income taxes that better meets the needs of taxpayers, the State, and local governments.



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MITCHELL E. DANIELS, JR., Governor
THOMAS O. SHARP, Commissioner

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March 18, 2005

State Board of Accounts
IGCS, Room E418
Indianapolis IN 46204

Subject: Response to Audit Finding - - Fiscal Year 2004 CAFR

FINDING 2004-CAFR-2 INFRASTRUCTURE

The Indiana Department of Transportation (INDOT) does not have complete written internal procedures to ensure that all applicable infrastructure assets are capitalized on the Auditor of State's capital asset system. INDOT has not documented procedures that would enable employees to determine which costs and at what point in the process these costs should be capitalized. This results in an understatement of the State's capital assets.

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Department of Transportation's Response

Since the implementation of the GASB34 reporting requirements, INDOT has continued to work with the Auditors in developing procedures for reporting infrastructure activity. The Auditors and INDOT staff have continued to refine the GASB34 reporting model for Fiscal Year 2005. Specific procedures are being developed and implemented to ensure that all applicable infrastructure assets from July 2004 shall be included on the Auditor of State's capital asset system. Thereafter, INDOT staff shall document the process and procedures.

Signed: Richard Whitney
Richard Whitney

Title: Chief Financial Officer

Date: 3/18/05